Supreme Court, U.S.
FILED

941041 DEC 9 1994

No. —— OFFICE OF THE CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

JACK R. HAWKINS and CYNTHIA HAWKINS,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

69 pp

QUESTION PRESENTED

Whether a punitive damages award received in a personal injury suit is excludable from gross income as "any damages . . . received on account of personal injuries. . . ." 26 U.S.C. § 104(a)(2).

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---

PETITION FOR A WRIT OF CERTIORARI

Petitioners Jack R. Hawkins and Cynthia Hawkins respectfully pray that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit in this matter.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 30 F.3d 1077 (9th Cir. 1994), and is reprinted in the appendix hereto at 1a-21a. The decision of the district court is reported at 93-1 U.S. Tax Cas. (CCH) ¶ 50,208 (D. Ariz. 1993), and is reprinted in the appendix at 22a-24a.

JURISDICTION

The Ninth Circuit issued its decision on July 19, 1994. A timely petition for rehearing and suggestion for rehearing en banc was denied on September 13, 1994.

This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 61(a) of the Internal Revenue Code of 1986, 26 U.S.C. § 61(a), provides in relevant part:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

2. Section 104(a) of the Internal Revenue Code, 26 U.S.C. § 104(a), provides in relevant part:

> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> . . . . .
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

3. Section 1.104-1(c) of the Treasury Regulations, 26 C.F.R. § 1.104-1(c), provides:

> Section 104(a)(2) [of the Internal Revenue Code] excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

STATEMENT

This case raises the issue whether punitive damage awards received in a personal injury suit are excluded from federal income tax.

In 1978, Cynthia Hawkins, driving a car owned by herself and her husband and insured by Allstate Insurance Company, was involved in a serious automobile accident which demolished the Hawkinses' car. Allstate, acting in bad faith, failed to meet its obligations with respect to the replacement of the Hawkinses' car.

The Hawkinses sued Allstate in state court in Arizona and were awarded compensatory damages as well as punitive damages of $3.5 million, *see Hawkins v. Allstate Ins. Co.*, 733 P.2d 1073, 1077 (Ariz.), *cert. denied*, 484 U.S. 874 (1987), all of which were paid by Allstate in 1988.

On their 1988 federal income tax returns, the Hawkinses reported the punitive damages award (less attorneys' fees and costs) as taxable income. They subsequently filed an amended return asserting that the punitive damages were excludable from gross income as "damages received . . . on account of personal injuries . . . ," 26 U.S.C. 104(a)(2), and sought a refund. Petitioners' Appendix at 4a (hereinafter "Pet. App."). The Internal Revenue Service disallowed the refund. The Hawkinses then initiated this tax refund case in the United States District Court for the District of Arizona.

At trial, it was conceded by the government (and accepted by the district court and Ninth Circuit) that "the Hawkinses suffered 'personal injuries' as a result of Allstate's conduct . . . [and that therefore] the Hawkinses' *compensatory* damages are excludable 'damages received . . . on account of personal injury [sic].'" Pet. App. at 4a (emphasis in original). Hence, the sole issue was whether the Hawkinses' punitive damages, received in connection with the same "personal injury" tort claim that gave rise to the compensatory damages, were also excluded from gross income pursuant to Section 104(a)(2).

On cross-motions for summary judgment, the district court granted the Hawkinses' motion and denied the

United States's motion, concluding that the Hawkinses' punitive damages award was excluded from gross income under Section 104(a)(2). The district court cited to *United States v. Burke,* 112 S. Ct. 1867 (1992), and reasoned that because personal injury was the requisite for the award of punitive damages to the Hawkinses, the statutory exclusion from gross income of "any damages received . . . on account of personal injuries" included punitive as well as compensatory damages.

On appeal, a divided panel of the Ninth Circuit reversed and held that punitive damages received in a personal injury suit are not excludable from gross income pursuant to Section 104(a)(2). In so doing, the majority (Judges Goodwin and Ferguson), refused to follow an earlier Ninth Circuit panel, *Roemer* v. *Commissioner,* 716 F.2d 693 (9th Cir. 1983), rejected two almost unanimous en banc Tax Court decisions, *Miller v. Commissioner,* 93 T.C. 330 (1989) (15 to 2), *rev'd,* 914 F.2d 586 (4th Cir. 1990), and *Horton v. Commissioner,* 100 T.C. 93 (1993) (16 to 3), *aff'd* 33 F.2d 625 (6th Cir. 1994), and found that this Court's decision in *Burke,* 112 S. Ct. at 1872 (focusing, "for purposes of § 104(a)(2), on the nature of the claim underlying [the taxpayers'] damages award"), had no application. The majority acknowledged that reasonable minds could differ, noting that "the dissent's interpretation of § 104(a)(2) is reasonable" (Pet. App. at 8a n.4), and that even the IRS had "twice reversed its opinion as to whether § 104(a)(2) excludes punitive damages awarded in a personal injury suit" (Pet. App. at 5a n.2), and urged Congress to "clear up the issue." *Id.* at 10a n.7.

The majority accepted the government's argument that Section 104(a)(2) requires a taxpayer to prove both that (1) the damages were recovered in a tort-like suit, and (2) the damages were received "on account of the personal injury." *Id.* at 8a. While recognizing that the Hawkinses' punitive damages were indisputably recovered in a tort-like suit, the majority concluded that the punitive

damages were not received "on account of personal injuries" because they are not compensatory in nature and bear no relationship to actual injuries. In support of its conclusion, the majority argued that the rationale undergirding Section 104(a)(2) was the principle that damages received through litigation or agreement should not be taxed when they represented a "restoration of capital." *Id.* at 11a-12a (quoting *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)) (" 'Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss to personal rights because, in effect, they restore a loss to capital' "). The majority concluded that as the Hawkinses' punitive damages were not compensatory, they represented a windfall and not a restoration of capital, and should therefore not be excluded from gross income pursuant to Section 104(a)(2). Pet. App. at 12a-13a.

In dissent, Judge Trott observed that the exclusion from gross income in Section 104(a)(2) of *"any* damages" (emphasis added) received on account of personal injury "suggests 'all damages' " and "simply does not permit a distinction between compensatory and punitive damages": "If Congress intended to exclude only compensatory damages from gross income, it certainly could have made that distinction explicit." *Id.* at 14a.

Instead of the two-part test followed by the majority, the dissent adopted the approach of a nearly unanimous Tax Court sitting en banc in *Horton*: "The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' This inquiry is answered by determining the nature of the underlying claim." *Id.* at 16a (quoting *Horton v. Commissioner*, 100 T.C. at 96). Because the Hawkinses' underlying claim was for "personal injury," the dissent concluded that punitive damages received on account of that claim were excludable.

The dissent found support for its interpretation of Section 104(a)(2) in this Court's decision in *Burke*,

which focused on the nature of the underlying claim as the sole determinant of exclusion under Section 104(a)(2). Citing the statement in *Burke* that "the concept of a 'tort' is inextricably bound up with remedies," the dissent reasoned that because punitive damages are one of the primary indicia of a personal injury claim, it follows that punitive damages are received "on account of personal injury." Pet. App. at 17a. The dissent rejected the "illogical" conclusion that, while the availability of punitive damages made the claim tort-like and rendered compensatory damages excludable from gross income under Section 104(a)(2), the punitive damages themselves are unrelated to the personal injury and should be taxable.

The dissent further noted that Section 104(a)(2) was amended, effective July 10, 1989, to provide that the section's exclusion from gross income "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379.[1] The dissent cited *Burke*, 112 S. Ct. at 1877 n.6, for the proposition that "Congress amended § 104(a) to allow the exclusion of punitive damages only in cases involving 'physical injury or physical sickness.'" Pet. App. at 18a-19a. The dissent pointed out that, while "[c]ommentators overwhelmingly agree with this interpretation of the 1989 amendment" (*id.* at 19a n.3), the majority's apparent position that all punitive damages are taxable, both before and after 1989, meant that the 1989 amendment "had no effect." *Id.*

Finally, the dissent criticized the majority's embrace of the rationale of the restoration of capital as the basis for Section 104(a)(2), a rationale which the dissent pointed out "has been widely criticized as a means of explaining the § 104(a)(2) exclusion." *Id.* at 20a. This theory

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[1] The amendment does not apply to punitive damages received under agreements made, or pursuant to suits filed, before July 10, 1989. *Id.*

could not explain why compensatory damages (e.g., lost wages) were *not* taxable while the items for which they compensated would have been had they been received in the ordinary course. Moreover, the theory would require an absurd effort to find the tax basis for the human body, since any damages in excess of that basis would be a windfall rather than a restoration of capital. *Id.*

REASONS FOR GRANTING THE WRIT

The Ninth Circuit's ruling—that Section 104(a)(2) does not exclude from gross income punitive damage awards received in personal injury suits because such damages are not compensatory in nature—warrants review by this Court for three reasons. First, there is not only a conflict between the circuits, but a conflict within the Ninth Circuit as well as a conflict with the Tax Court, a national court given the primary responsibility for interpreting the nation's tax laws. The Ninth Circuit's decision in *Hawkins*, as well as the Fourth Circuit's decision in *Miller v. Commissioner* and the Federal Circuit's decision in *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994), squarely conflict with the Sixth Circuit's decision in *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994). The decision in *Hawkins* also conflicts with the Ninth Circuit's decision in *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994),[2] and its decision eleven years earlier in *Roemer*.[3] Finally, *Hawkins* is in conflict with

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[2] The government has acknowledged this intra-circuit split in its Petition for Writ of Certiorari in *Commissioner v. Schleier*, No. 94-500 (cert. granted November 14, 1994). Pet. App. at 40a-41a ("as Judge Trott noted concurring in the result in *Schmitz* . . ., the Ninth Circuit's decision . . . conflicts with the Ninth Circuit's own prior decision in *Hawkins v. United States*").

[3] The majority in *Hawkins* departed from *Roemer* on the ground that *Roemer* relied solely "on a 1975 Revenue Ruling which has since been overruled." Pet. App. at 8a. *See* n.13, *infra*. *Roemer* was cited with approval by the Supreme Court just two years earlier. *Burke*, 112 S. Ct. 1871 n.6.

the nearly unanimous holdings of the Tax Court in *Miller* and *Horton*. While *Miller* has been reversed by the Fourth Circuit, the Sixth Circuit affirmed the Tax Court in *Horton*, thus making it unlikely that the Tax Court will alter its position. This lack of uniformity throughout the judicial system, with respect to an important provision of the Internal Revenue Code, ought not to be allowed. Resolution of these conflicts are necessary to prevent taxpayers from being subject to federal taxation, or not, depending upon the happenstance of their residence.

Second, the Ninth Circuit's approach in this case was fundamentally wrong. The court had no justification for departing from the language of the statute in favor of a dubious policy rationale—especially when such an approach is at odds with the implications of this Court's decision in *Burke* and Congress' 1989 amendment. The statute plainly provides that "any damages" received "on account" of personal injury are excluded from gross income. The most straightforward way to understand this language, especially in light of the 1989 amendment, is that "any" (that is, "all") damages received "on account of" (that is, "through a claim for") personal injury are not taxable.[4]

Finally, the meaning of Section 104(a)(2) is of continuing importance and is before the Court this term in *Commissioner v. Schleier*, No. 94-500 (cert. granted November 14, 1994). In that case, the government has argued that liquidated damages received under the Age Discrimination and Employment Act ("ADEA"), 26 U.S.C.

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[4] Notwithstanding the *Hawkins* majority's view that Section 104(a)(2) is "ambiguous," the government now contends in its Petition for Certiorari in *Schleier* that the plain meaning of the statute would exclude punitive damages. Pet. App. at 39a ("Punitive damages . . . do not come within the literal terms of the exclusion from income provided by Section 104(a)(2). That conclusion . . . appears plain enough on the face of the statute.") (footnote omitted).

§§ 621 et seq., should not be excluded from gross income under Section 104(a)(2). In its Petition for Certiorari in *Schleier*, the government argues that Section 104(a)(2) should be interpreted according to precisely the same two-part test adopted by the Ninth Circuit majority here and that liquidated damages received under ADEA should accordingly not be excluded from income because, like punitive damages, they are not "on account of" personal injuries. In support of this argument, the government cites the appellate decision in this case, as well as those in *Miller* and *Reese*. Pet. App. at 38a-39a. Fairness, completeness, and judicial economy counsel resolution of the overlapping circuit conflicts presented in *Schleier* and here.

I. THE DECISION BELOW SQUARELY CONFLICTS WITH A RULING FROM THE SIXTH CIRCUIT; MOREOVER, THE FEDERAL JUDICIARY IS IN DISARRAY WITH RESPECT TO THE ISSUE RAISED HEREIN.

The Ninth Circuit's decision, as well as the decisions of the Fourth Circuit in *Miller* and the Federal Circuit in *Reese*, squarely conflict with the Sixth Circuit's decision in *Horton* and two nearly unanimous opinions of the United States Tax Court sitting en banc. *See Miller v. Commissioner*, 93 T.C. 330, 338 (1989), *rev'd* 914 F.2d 586 (4th Cir. 1990) (15 to 2 decision); *Horton v. Commissioner*, 100 T.C. 93, 95 (1993), *aff'd* 33 F.2d 625 (6th Cir. 1994) (16 to 3 decision expressly rejecting the reasoning and holding of the Fourth Circuit in *Miller*). It also conflicts with the Ninth Circuit's previous ruling in *Roemer*.[5]

The Sixth Circuit's opinion in *Horton* was rendered two months after the Ninth Circuit's divided decision here. In

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[5] Although the conflict with *Roemer* was argued by the Hawkinses as a principal reason for their suggestion for rehearing en banc, no active Ninth Circuit judge requested a vote on the Hawkinses' suggestion. Pet. App. at 25a.

Horton, the panel, also divided, discussed and explicitly rejected the Ninth Circuit's holding and rationale. *Horton* also considered and rejected the arguments advanced in *Miller* and *Reese*.[6]

The Sixth Circuit in *Horton* addressed each of the arguments advanced by the Ninth Circuit in *Hawkins* and found them wanting.[7] While the Ninth Circuit found the Supreme Court's decision in *Burke* to be "unpersuasive" (Pet. App. at 8a), the Sixth Circuit found it to be "instructive" and its language to be "directive." *Horton*, 33 F.3d at 629, 630.[8] While the Ninth Circuit thought the language of Section 104(a)(2) to be "ambiguous" (Pet. App. at 5a), the Sixth Circuit felt its meaning to be "plain." *Horton*, 33 F.3d at 631. While the Ninth Circuit found the 1989 amendment to Section 104(a)(2) to be only a "clarif[ication of] existing law," and "doubt[ed] that Congress intended [by it] to exclude *any* noncompensatory punitive damages" (Pet. App. at 10a and 10a n.7, emphasis added), the Sixth Circuit concluded that "the clear implication of [the amendment] is that punitive damages in a case involving physical injury or physical

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[6] The majority in *Horton* noted that it "disagree[d] with the Ninth Circuit's opinion in *Hawkins*, the Federal Circuit's opinion in *Reese*, and the Fourth Circuit's opinion in *Miller*. We agree with the cogent reasoning of Judge Trott's dissenting opinion in *Hawkins*." *Horton*, 33 F.3d at 630 n.9.

[7] The arguments adopted by the Ninth Circuit in *Hawkins* are substantially the same as the arguments advanced by the Fourth Circuit in *Miller* and the Federal Circuit in *Reese*.

[8] In *Burke*, the Supreme Court "focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damages award. . . . In order to come within the § 104(a)(2) income exclusion, respondents . . . must show that Title VII . . . redresses a tort-like personal injury." *Burke*, 112 S. Ct. at 1872. *Horton* cited *Burke* as approving the Sixth Circuit's view, as articulated in *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988), that "the narrow scope of our gaze is properly limited to the 'origin and character of the claim.'" *Horton*, 33 F.3d at 630.

sickness are excludable, and were excludable even before the amendment." *Horton*, 33 F.3d at 631 n.12. While the Ninth Circuit believed that the purpose of Section 104(a)(2) was to exclude from gross income damages that "make the taxpayer whole . . . [by] restor[ing] a loss to capital" (Pet. App. at 11a), the Sixth Circuit found the distinction between damages which make a taxpayer "whole" and those which are "mere accessions to wealth" to be a "false dichotomy." *Horton*, 33 F.3d at 632. What both circuits might have agreed on was that "[w]e proceed knowing that '[a] consensus on this issue within the federal judiciary is nonexistent.'" *Id.* at 627 (citation omitted).[9]

The practical import of this lack of consensus is evident. In the Ninth and Fourth Circuits, the Tax Court will be compelled to follow the rule that punitive damages in connection with personal injury claims are not excluded from gross income. In all other circuits, including the Sixth, the Tax Court will apply the contrary rule.[10]

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[9] As but one of its numerous grounds for holding that punitive damages were excluded from gross income under Section 104(a)(2), the majority in *Horton* noted that the Kentucky Supreme Court had indicated that punitive damages had a compensatory component in that "'the *injury* has been *increased* by the *manner* [in which] it was inflicted,'" *Horton*, 33 F.3d at 631 (citation omitted) (emphasis in original), and suggested that this might be a factor distinguishing *Horton* from *Hawkins*. The dissent properly noted, however, that the Kentucky Supreme Court's "explanation of why the concept of punitive damages should not be discarded [does not] make[] punitive damages in Kentucky somehow different from other states." *Id.* at 632. Other courts have attempted to explain punitive damages in a fashion similar to that of Kentucky. *See* W. Page Keeton *et al.*, *Prosser* and *Keeton on the Law of Torts* § 2, at 9 (5th ed. 1984) ("Occasional decisions have mentioned the additional purpose of [punitive damages of] reimbursing the plaintiff for elements of damages which are not legally compensable, such as wounded feelings or the expenses of suit") (footnote omitted).

[10] The Tax Court considered the Fourth Circuit's reversal in *Miller* yet hewed to its reasoning when revisiting the issue in

Immediate resolution of this conflict between the circuits, and between several of the circuits and the Tax Court, is necessary to prevent taxpayers in different circuits from being subject to disparate federal tax treatment.[11]

There is no possibility that this conflict will ameliorate of its own accord. Its existence was brought to the attention of the Ninth Circuit in the Hawkinses' petition for rehearing while the Hawkinses' petition for rehearing and suggestion for rehearing en banc was pending, yet rehearing was denied. The Sixth Circuit in *Horton* was similarly cognizant of the split, yet specifically refused to follow the Ninth Circuit, the Fourth Circuit, and the Federal Circuit. The time for seeking rehearing in *Horton* has expired, and the mandate has issued. The Fourth Circuit decision in *Miller* and the Federal Circuit's decision in *Reese* are also final.

Horton. Now that the Tax Court's approach has been vindicated by the Sixth Circuit, there can be little doubt that the Tax Court will continue to recognize the excludability of punitive damages received in personal injury suits in all circuits in which it has the authority to do so, i.e., everywhere outside of the Fourth and Ninth Circuits.

[11] The Tenth Circuit is likely to be the next to take sides in this circuit split. In *O'Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567 (D. Kan. 1992), the district court initially held, relying on the Fourth Circuit's decision in *Miller*, that punitive damages in a wrongful death suit were not excludable from gross income. However, following this Court's decision in *Burke*, the district court reconsidered its determination and, in an unpublished decision, reversed itself. *See id.* at ¶ 85,974-75 ("The Supreme Court's opinion [in *Burke*] makes clear that the proper inquiry for purposes of § 104(a)(2) is on the nature of the claim underlying the taxpayers' damages award"). The district court's decision is presently on appeal to the Tenth Circuit.

II. THE NINTH CIRCUIT'S APPROACH FLOUTS THE PLAIN LANGUAGE OF THE STATUTE, IS INCONSISTENT WITH THE GOVERNING TREASURY REGULATION, RESTS ON A DISCREDITED POLICY RATIONALE, AND IS AT ODDS WITH THE 1989 AMENDMENT AS WELL AS THE SUPREME COURT DECISION IN *BURKE*.

On the merits, it is difficult to defend the Ninth Circuit's decision in this case to abandon the language of the statute in favor of a policy rationale that has been thoroughly discredited.[12]

A. Section 104(a)(2) provides that gross income does not include "*any* damages received . . . on account of personal injuries or sickness" (emphasis added). The plain meaning of Section 104(a)(2) is that *"any"* damages, that is *all* damages, received on account of personal injury are excluded from gross income. That should be the end of the analysis. *See Crane v. Commissioner*, 331 U.S. 1, 6, 67 S. Ct. 1047, 1051 (1947) ("the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses").

The majority suggests that Section 104(a)(2) is ambiguous in two ways. First, it states that " '[d]amages received on account of personal injury [sic]' could mean all damages received in a personal injury lawsuit, or, it could mean only those damages which purport to compensate the taxpayer for her personal injuries." Pet. App. at 5a.

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[12] In dissent, Judge Trott posited that the majority's approach was borne of good intentions:

> The majority tries to impose some logic and commonsense [sic] on § 104(a)(2). Despite their efforts, I fear they might sow more confusion than clarification. Congress should straighten out this mess, but until they do, we must do our best to apply the statute as it is written and as we believe Congress intended. We cannot contradict the statute's plain language in an effort to impose order in the sometimes-chaotic world of the tax code.

Pet. App. at 21a.

But the majority's choice of the latter construction of Section 104(a)(2), by which the exclusion applies to "compensatory" damages only, runs afoul of the text, which explicitly provides that the exclusion applies to "any damages" received on account of personal injury. As the dissent observes, "any damages" surely suggests "all damages." Pet. App. at 14a; *see also Horton v. Commissioner*, 100 T.C. at 95.[13]

Cognizant of this problem, the majority attempts to disarm the nettlesome word "any" by suggesting that it "could indicate an intent to make all of the[] various kinds of compensatory damages excludable." Pet. App. at 6a n.3. This interpretation begs the question, however, because it requires that "any damages" be read as "any compensatory damages."

Alternatively, the majority argues that the phrase "on account of" personal injury "could mean . . . all damages to which a litigant is entitled because of her injuries, but not those which serve solely to punish the wrongdoer." *Id.* This strained reading of "on account of" again departs from the text. It requires effective emendation of the statute so that Section 104(a)(2) states, "any damages . . . on account of personal injury[, unless they serve solely to punish the wrongdoer]." This is not what Congress wrote.

Moreover, this interpretation of the phrase "on account of" is contrary to Treasury Regulation Section 1.104-1(c),

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[13] At one time, the Commissioner acknowledged this point. *See* Revenue Ruling 75-45, 1975-1 C.B. 47 ("Section 104(a)(2) . . . excludes from gross income 'the amount of *any* damages received . . . *on account of* personal injuries or sickness' . . . Therefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income") (emphasis in original). The Commissioner later reversed his position in Revenue Ruling 84-108, 1984-2 C.B. 32, 34, based primarily on a mistaken understanding of an inapposite Supreme Court case. *See Miller*, 93 T.C. at 339.

promulgated under Section 104(a)(2). Treasury regulations, which set forth the Treasury's official interpretation of the revenue statutes, are entitled to considerable deference. *See Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501, 68 S. Ct. 695, 698 (1948) (Treasury regulations must be upheld "unless unreasonable and plainly inconsistent with the revenue statutes").[14]

In the apposite regulation, the Treasury interprets "damages received" to mean "an amount received (other than workmen's compensation) *through* prosecution of a legal suit or action based upon tort or tort type rights, or *through* a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. § 1.104-1(c) (1991) (emphasis added).[15] Although the regulation ostensibly defines only the meaning of "damages received," it gives sense to the entire phrase "damages received . . . on account of personal injuries." In doing so, the Treasury regulation looks only to the causal source of the damage—tort or tort type rights—to determine excludability, not the type of damage received. Indeed, in *Burke*, a majority of this Court accepted the soundness of this Treasury regulation and deferred to it. *See Burke*, 112 S. Ct. at 1875 (Scalia, J., concurring in the judgment) ("The court accepts at the outset of its analysis the Internal Revenue Service regulation"); *see also id.* at 1878 (O'Connor, J., dissenting) ("The Court properly defers to an Internal Revenue Service . . . regulation").

The majority's suggestion that Congress intended a distinction that is not articulated in the statute is thus inconsistent with normal canons of interpretation, *see Crane*, 331 U.S. at 6. 67 S. Ct. at 1051, as well as the Treasury's

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[14] The same deference is not due to Revenue Rulings. *Dixon v. United States*, 381 U.S. 68, 73, 85 S. Ct. 1301, 1304 (1965); *Propstra v. United States*, 680 F.2d 1248, 1256 (9th Cir. 1982) (Revenue Rulings are only "occasionally entitled to weight in the interpretive process").

[15] The Ninth Circuit majority did not consider, much less explain, its departure from the governing Treasury regulation.

view of the meaning of the statute. It is also contrary to common sense. As the Tax Court observed, "Congress, aware of [the availability of punitive damages], could have excluded only 'compensatory damages' or provided that only damages received 'as compensation for' personal injuries be excluded. . . . It did neither." *Horton*, 100 T.C. 93, 95 (1993) (quoting *Miller v. Commissioner*, 93 T.C. at 338).

B. The crux of the majority's analysis is that Section 104(a)(2) is ambiguous. The majority then posits its policy rationale—"restoration of capital"—and attempts to interpret the statute in its light.

Even were the majority correct that the language of Section 104(a)(2) did not compel the exclusion from gross income of punitive damages obtained in tort type cases, its reliance on a restoration of capital rationale to interpret the statute is misplaced. In *Burke*, 112 S. Ct. at 1871 n.6 (1992), this Court described Section 104(a)(2), amended in 1989, as "allow[ing] the exclusion of *punitive* damages . . . in cases involving 'physical injury or physical sickness' " (emphasis in original). In other words, this Court recognized that at least one class of punitive damages—those in cases involving physical injury—is excluded from income. Were restoration of capital the rationale for Section 104(a)(2), no punitive damages should be excludable.

The majority in *Hawkins* was aware of this inconsistency, albeit unable to overcome it. Instead, the majority conceded the issue, forthrightly noting that "[g]iven our belief that excluding punitive damages is inconsistent with § 104(a)(2)'s title and purpose, we doubt that Congress intended to exclude any noncompensatory punitive damages." Pet. App. at 10a n.7. The majority's conclusion, which is driven by the restoration of capital rationale, is flatly inconsistent with *Burke*.[16]

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[16] The same problem faces the government in *Schleier*, where it also urges a construction of Section 104(a)(2) that would result

Even were the restoration of capital theory not at loggerheads with this Court's precedent, the Tax Court and numerous commentators have observed that the restoration of capital theory cannot explain Section 104(a)(2) because the provision excludes damages that are a substitute for "items that otherwise would be taxable or would potentially produce taxable benefit, such as income lost as a result of a personal injury or amounts reflecting injury to a person's business or professional reputation," i.e., items that are conceptually income rather than returned capital. *Downey v. Commissioner*, 97 T.C. 150, 163 (1991), supp. op., 100 T.C. 634 (1933), *rev'd on other grounds*, 33 F.3d 836 (7th Cir. 1994); *see also Horton*, 100 T.C. at 96 n.4 (citing commentators). Moreover, the core concept of the restoration of capital rationale—the existence of "human capital" that can be restored—finds no recognition in the Tax Code. In the words of one commentator:

> If a personal injury involves a loss of human capital, then it follows that there should be a deduction for uncompensated personal injury losses [, but] no such deduction exists. . . . [I]f one has basis in human capital, there should be depreciation deductions to offset wages, but again none exist.

Joseph M. Dodge, *Taxes and Torts*, 77 Cornell L. Rev. 143, 153 (1992) (footnotes omitted).

In sum, whatever the policy appeal of the restoration of capital rationale, it cannot explain Section 104(a)(2). It thus cannot be used as the touchstone for correct interpretation of the statute.[17]

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in all punitive damages being included in gross income. There, the government has attempted to overcome this Court's statement in *Burke* by characterizing it as mere "dicta." Pet. App. at 39a n.10.

[17] Commentators have concluded that no single policy can adequately account for items excluded under Section 104(a). *See, e.g.*, Margaret Henning, *Recent Developments in the Tax Treatment*

C. In 1989, Congress amended Section 104(a)(2) to provide that the provision's exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989). This amendment does not apply to any recovery of punitive damages under an agreement made, or pursuant to a suit filed, on or before July 10, 1989. *Id.* at § 7641(b)(2). The reasonable implication from the 1989 amendment is that, as to recoveries on suits filed or agreements made prior to July 10, 1989, all punitive damages on account of personal injury were not taxable; as to recoveries on suits filed or agreements made after July 10, 1989, only punitive damages received in personal injury cases involving physical injury or sickness are excludable. *See Burke*, 112 S. Ct. at 1871 n.6 ("Congress amended § 104(a) to allow the exclusion of *punitive* damages only in cases involving 'physical injury or physical sickness' ") (emphasis in original).

The 1989 amendment makes no sense—and has no effect—if viewed with the majority's assumption that before that year Section 104(a)(2) did not apply to any type of punitive damages—those arising in physical injury as well as nonphysical injury cases. The majority in *Hawkins* also recognized this difficulty, but rationalized that Congress may have engaged in an effectively pointless amendment to "clarify existing law." Pet. App. at 9a. This conjecture offends common sense, however, for "if Congress wanted to clarify that all punitive damages were taxable, why did the amendment create a distinction between physical and nonphysical injury?" Pet. App. at 19a (Trott, J., dissenting). In short, the 1989 amendment is further evidence that punitive damages obtained in all personal injury suits were excludable from gross income prior to 1989.

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of Personal Injury and Punitive Damage Recoveries, 45 Tax Law. 783, 795-97 (1992).

III. THE ISSUE PRESENTED IS ONE OF CONTINUING IMPORTANCE.

The interpretation of pre-amendment Section 104(a)(2) "remains one of substantial importance in the administration of the income tax laws for earlier taxable years." *Colony Inc. v. Commissioner,* 357 U.S. 28, 32, 78 S. Ct. 1033, 1035 (1958); *see also Watson v. Commissioner,* 345 U.S. 544, 547, 73 S. Ct. 848 (1953) (certiorari granted to resolve conflicting constructions of amended provisions of Internal Revenue Code because of significance for earlier taxable years). The 1989 amendment does not apply to recoveries of punitive damages in connection with suits filed before July 10, 1989. Many such suits may still be pending, or recoveries thereon subject to audit for years to come. Given the frequency of punitive damages awards, the resolution of the circuit split at bar has potential ramifications for untold numbers of taxpayers. *Cf. Pacific Mut. Life Ins. Co. v. Haslip,* 499 U.S. 1, 61, 111 S. Ct. 1032, 1066 (1991) (O'Connor, J., dissenting) (citations omitted) ("Recent years . . . have witnessed an explosion in the frequency and size of punitive damages awards. . . . A recent study by the RAND Corporation found that punitive damages were assessed against one of every ten defendants who were found liable for compensatory damages in California").

Moreover, on November 14, 1994, this Court granted review in *Commissioner v. Schleier,* No. 94-500, which raises a similar issue as to the meaning of the same pre-amendment language of Section 104(a)(2) as is at issue here. ADEA provides a remedy for wrongful discharge damages equal to back pay, plus an award of "liquidated damages" in an amount equal to the back pay award "in cases of willful violations." 29 U.S.C. § 626(b). It is well established that "ADEA liquidated damages do not duplicate state damage awards for lost interest, emotional distress, and pain and suffering." *Schmitz,* 34 F.3d at 796 n.8.

Schleier obtained a settlement for back pay and liquidated damages in 1986, and thereafter asserted that both were excluded from gross income under the pre-1989 amendment language of Section 104(a)(2). The Tax Court followed its earlier decisions in *Downey v. Commissioner*, 97 T.C. 150 (1991), supp. op., 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), which held that liquidated damages, notwithstanding their partially punitive purpose, were "on account of personal injuries" since ADEA "evidences a tort-like conception of injury and remedy." *Downey*, 100 T.C. at 637. The Fifth Circuit affirmed in an unpublished opinion, *Schleier v. Internal Revenue Service*, No. 93-5555 (filed June 21, 1994), thus aligning itself with the Ninth Circuit decision in *Schmitz* and placing it in opposition to the Seventh Circuit's decision in *Downey*.

Like *Schleier*, the issue raised in the present Petition is whether, under the pre-1989 amendment language of Section 104(a)(2), the test for exclusion from gross income is the nature of the action (is it a tort-like suit?) or the nature of the remedy (does it serve a compensatory or punitive purpose?). Thus, in its Petition for Certiorari in *Schleier*, the government argues:

> Even if the ADEA were thought to represent a tort-type remedy for a personal injury, any liquidated damages awarded under that Act would not be excludable from gross income under Section 104 (a)(2). When applicable, Section 104(a)(2) permits exclusion only of damages received "on account of" personal injuries . . . . As the Fourth Circuit concluded in *Commissioner v. Miller*, damages awarded as punishment of a wrongdoer, rather than as compensation for an injury, are awarded "on account of" malice or willfulness, not "on account of" personal injury. 914 F.2d at 589-592. Accord, *Hawkins v. United States* . . .; *Reese v. United States* . . . . Punitive damages and statutory penalties for "willful violations" of the law thus do not come within

> the literal terms of the exclusion from income provided by Section 104(a)(2) . . . .
>
> . . . . .
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> In our view, the conclusion expressly reached . . . by the Ninth Circuit in *Schmitz* . . . conflicts with the conclusion of the Fourth and Federal Circuits in *Commissioner v. Miller, supra,* and *Reese v. United States, supra,* that damages awarded to penalize a wrongdoer are not awarded "on account of personal injuries" within the meaning of Section 104(a)(2). Moreover, as Judge Trott noted concurring in the result in *Schmitz* . . . the Ninth Circuit's decision on this issue conflicts with the Ninth Circuit's own prior decision in *Hawkins v. United States* . . . .

Pet. App. at 38a-41a (citations and footnotes omitted). Thus, in *Schleier,* the government has squarely put the interpretation of Section 104(a)(2) followed by the *Hawkins* majority before this Court for decision. This Court's determination of whether liquidated damages, imposed for "willful violations" of ADEA, are "on account" of personal injury ought, and is likely, to include an analysis of the similarities between liquidated and punitive damages. As Judge Trott wrote in his concurring opinion in *Schmitz*:

> The majority . . . has to square this result with the test they created in *Hawkins.* . . . I don't see how the majority can distinguish ADEA liquidated damages from punitive damages. I think this inconsistency merits attention because it demonstrates problems with the majority's approach in both this case and *Hawkins.*

34 F.3d at 797 (Trott, J., concurring).

The circuit split on punitive damages thus mirrors and overlaps the circuit split on ADEA liquidated damages. For reasons of completeness, fairness, and judicial economy these related issues should be resolved. Although deferring action on this Petition until *Schleier* is decided might assure no blatant inconsistency between the result

applicable to the Schleiers and that applicable to Petitioners here, it would not assure the full resolution of this recurring issue. Whether liquidated damages imposed for willful violations of ADEA, and punitive damages awarded for egregious conduct, should be excluded from income ought to be decided through consistent reasoning.

Finally, the meaning of the phrase "damages received . . . on account of personal injuries," as used in Section 104(a)(2), has important, continuing ramifications as to the proper tax treatment of punitive damages received in connection with agreements made or suits filed after July 10, 1989, in cases involving physical injury. Even as to such post-July 10, 1989 agreements or suits, if the interpretation urged by the *Hawkins* majority, and the government in *Schleier*, of the phrase "on account of" is correct, no punitive damages, including punitive damages received in cases involving physical injury or sickness, are excludable from gross income. Rejection of the *Hawkins* majority's interpretation of "on account of" would, conversely, allow for the exclusion of punitive damages received in connection with an agreement made or suit filed after July 10, 1989, in a case involving physical injury or sickness.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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